Business Planning

Cross-Purchase Buy-Sell Agreement

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Summary

WHAT IS A CROSS-PURCHASE BUY-SELL AGREEMENT?

A buy-sell agreement provides that, if one of the owners of a business dies, the other owners will purchase the deceased owner's interest. Equally important, it obligates the deceased's heirs to sell the interest to the other owners.

The cross-purchase type of buy-sell agreement provides that each surviving owner individually purchase a portion of the deceased owner's interest. In another type—the entity buy-sell agreement—the business itself purchases the deceased's interest.

WHY IS IT NEEDED?

A buy-sell agreement helps ensure that a business can continue after an owner dies. When it's funded by life insurance, the agreement provides both the financing and the mechanism to ensure that control of the business will remain with the current owners, and the heirs will receive a fair price for their inherited interest.

HOW DOES IT WORK?

To provide funding, each owner buys a life insurance policy covering the life of every other owner. Each person owns the policies he or she buys and is the beneficiary of those policies.

Assume a partnership valued at $750,000 is owned by three equal partners—Risley, Radford and Wisman. With a cross-purchase agreement, each partner buys policies on the lives of the other two in the amount of $125,000 each, so that each partner is insured for a total of $250,000. Assume further that Wisman dies. The death benefits on the two policies insuring his life—one owned by Risley and one by Radford—are paid to the two surviving partners as beneficiaries of the policies. Result: the surviving partners have a total of $250,000 to purchase Wisman's business interest from his heirs.

WHAT'S THE TAX PICTURE?

The premiums individual owners pay are not tax-deductible. If, on the other hand, a corporation pays the premiums, they may be deductible if they are treated as compensation to the shareholder-employees on whose behalf they are paid. If the corporation's premium payments are treated as dividends to the shareholders, the premiums would not be deductible by the corporation and the shareholder receiving the dividend would be taxed at the "15 or 20%" rate on corporate dividends applicable to the shareholder.

Life insurance death proceeds are generally received federal income tax free.

WHAT ARE SOME OTHER BENEFITS?

With a cross-purchase buy-sell agreement in place, surviving owners are assured of having the funds to buy out a deceased owner's heirs and maintain control of the business.

While all the terms of the sale are decided in advance, the agreement should provide a mechanism—such as a periodic stock revaluation clause—so that the heirs receive a fair price for the deceased's interest.

The surviving owners receive an increase in basis that can reduce the capital gains taxes on any future sale of the business interest.

Finally, a properly drawn buy-sell agreement can fix the value of the business interest for federal estate tax purposes.

WHAT ARE SOME POTENTIAL DOWNSIDES?

A cross-purchase arrangement may be cumbersome when there are many owners, since multiple life insurance policies are required. For example, a business with six owners would require a total of 30 policies to fund the agreement (unless the business uses a trusteed approach).

When there is a wide age disparity among the owners, younger owners bear a greater premium burden to insure older owners.

Because the policies in a cross-purchase agreement are individually owned, cash values accumulating in the policies aren't available to the business.

Both the benefits and drawbacks should be considered in determining what type of agreement to put in place. The important thing is that, with any type of properly drawn-up and funded buy-sell agreement, owners of small businesses know that they are establishing a fair price for their business interest, and assuring that the people and the money to purchase that interest will be there when the situation arises.